United States Court of Appeals

for the Second Circuit

APPELLEE'S REPLY BRIEF

76-7607

No. 76-7619

To be argued by
HOWARD BREINDEL

In The

United States Court of Appeals

For The Second Circuit

UNIVERSITY HILL FOUNDATION,
Plaintiff-Appellee and Cross-Appellant,

-against-

GOLDMAN, SACHS & CO.,
Defendant-Appellant and Cross-Appellee.

Appeal from the United States District Court for the Southern District of New York (71 CIV. 1166 (MEL)).

REPLY BRIEF FOR PLAINTIFF-APPELLEE AND CROSS-APPELLANT UNIVERSITY HILL FOUNDATION

SOLIN & BREINDEL
Attorneys for Plaintiff-Appellee and Cross-Appellant
645 Fifth Avenue
New York, New York 10022
(212) 752-4407

9204 G

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REPLY BRIEF FOR CROSS-APPELLANT UNIVERSITY HILL FOUNDATION

INTRODUCTION

The Foundation submits this Brief in reply to various arguments raised in response to the Foundation's cross-appeal. This Reply Brief will demonstrate, inter alia, that:

1. the omissions of GS were necessary to make statements made by GS not misleading,

2. the omissions of GS were material and that the District Court did not rule that the omissions were not material,

3. expert testimony was not required to establish the materiality of the omissions,

4. factual information is material even if its disclosure is not specifically requested,

5. the holding in Chasins with respect to materiality has not been reversed by Ernst & Ernst or TSC, and

6. all trial courts which have ruled on the NCO omission issue have not ruled in GS' favor.

POINT I

DISCLOSURE OF THE OMISSIONS WAS NECESSARY TO MAKE THE STATEMENTS MADE BY GS NOT MISLEADING

GS claims that the Foundation ignores a "critical element of its case" by failing to establish that disclosure of the factual omissions by GS was necessary to make the statements made by GS in connection with its sale of Penn Central commercial paper to the Foundation not misleading. As demonstrated hereinafter*, not only did the Foundation establish that disclosure of the omissions was necessary to make GS' statements not misleading but, in addition, the finding of the District Court in connection therewith was in error.

As is relevant with respect to this issue, § 12(2) of the 1933 Act imposes liability on the seller of a security who:

> "...omits to state a material fact necessary in order to make the statements in light of

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* See also the Foundation's Brief, pp. 70, 80 and 83.

circumstances under which they were made, not misleading..."

A seller is therefore liable pursuant to § 12(2) if:

(1) he makes a statement,

(2) omits to state a material fact, and

(3) the omitted material fact was necessary to make the statment made not misleading.

In connection with GS' sale of Penn Central commercial paper to the Foundation, GS made the following statements, either expressly or impliedly:

(1) that in GS' opinion, Penn Central was creditworthy,

(2) that a reasonable basis existed for GS' opinion that Penn Central was creditworthy,

(3) that GS conducted an adequate and reasonable credit investigation of Penn Central,

(4) that GS recommended Penn Central commercial paper for sale, and

(5) that Penn Central commercial paper was "NCO prime".

GS, however, did not disclose to the Foundation, inter alia:

(1) GS' futile efforts to have Penn Central obtain, and Penn Central's continued inability or unwillingness to obtain, 100% bankline coverage for its commercial paper,

(2) that at the request of GS, Penn Central repurchased $10 million of GS' Penn Central commercial paper inventory on February 9, 1970 and GS simultaneously imposed an unprecedented $5 million limit on the amount of Penn Central commercial paper GS would inventory in the future, and

(3) that Brown Bros., a highly respected banking institution which had in the past held up to 15% of Penn Central's outstanding commercial paper, had removed Penn Central from its approved list of issuers on February 5, 1970.

For the reasons set forth in the Foundation's Brief* and Point II, infra, each of the foregoing facts was material. Furthermore, each of these facts should have been disclosed by GS in order to make one, or more, of the statements made by GS not misleading. Thus, the fact that the holder of 15% of Penn Central's outstanding commercial paper had removed Penn Central from its approved list of issuers (and that GS had made no productive effort to ascertain the reason for such removal) was clearly necessary to make GS' statement that an adequate credit investigation of Penn Central had been conducted not misleading.** Equally misleading was GS' recommendation of Penn Central commercial paper in the absence of the disclosure that GS required Penn Central to repurchase $10 million of its inventory and at the same time imposed a $5 million inventory limit on the amount of commercial paper it would inventory in the future, a restriction which had never been made by GS prior to that time in connection with any other non-financial commercial paper issuer. Finally, GS' statement that in its opinion Penn Central was creditworthy required the further statement that Penn Central would or could not obtain 100% bank line coverage (despite GS' continuous requests)

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* Point IV(B).

** See also the Foundation's Brief, p. 83.

in order to not be misleading. Indeed, the District Court essentially held that the aforementioned facts should have been disclosed in order to insure that GS' statements were not misleading when it stated that although the omitted facts were not "necessarily conclusive of the judgment" of Penn Central's creditworthiness, such facts were "all relevant to a judgment of creditworthiness." 422 F. Supp. at 896. Consequently, the Foundation established each prerequisite for liability pursuant to § 12(2), including the "critical element" it allegedly had ignored.

Contrary to the assertion of GS, the District Court did not hold that disclosure of the omissions was not necessary in order to make the statements made by GS not misleading. The District Court held that because the Foundation neither sought nor expected disclosure of the omitted facts regarding Penn Central and only relied upon GS' opinion regarding Penn Central's creditworthiness:

> "...none of the alleged omissions can be considered necessary 'in light of the circumstances' unless the omitted facts, of themselves, rendered a judgment that the Company [Penn Central] was creditworthy unreasonable. For the following reasons [that although the omitted facts were relevant to a judgment of creditworthiness, they are not conclusive of the judgment] we find that this is not true of any of the alleged omissions here." 422 F. Supp. at 895-896.

In the context of the District Court's discussion of Philips v. Reynolds & Co., 297 F. Supp. 736 (E.D. Pa. 1969),* and the cir-

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* Which GS concedes relates to the "extent disclosure is required." GS Reply Brief, p. 37.

cumstances of the commercial paper market, by the foregoing language the District Court (improperly*) held that because of the "special circumstances" of the Foundation's purchase, GS had no duty to disclose the omitted facts to the Foundation. It did not hold that the omissions were not required to make the statements made by GS not misleading but rather that the omissions did not have to be disclosed because GS' duty to disclose them was eliminated by the circumstances in the commercial paper market and the conduct of LeMay. Id.

In any event, assuming arguendo that the District Court concluded that GS was not liable for its failure to disclose the omitted facts because such facts were not necessary to make the statements made by GS not misleading, the District Court erred as a matter of law. If this assumed construction of the District Court's opinion is adopted, at the very least it is clear that the only conclusion of the District Court was that disclosure of the omitted facts was not necessary to make GS' statement that in GS' opinion Penn Central was creditworthy not unreasonable. However, by this holding, the District Court (improperly) limited GS' liability pursuant to § 12(2) in two respects:

(1) The additional statements made by GS other than that relating to GS' opinion of Penn Central's creditworthiness, supra, were disregarded, thereby giving no consideration to the fact that, as demonstrated above, the other statements made by GS were misleading as a result of GS' failure to disclose the omitted facts.

(2) An omission was made actionable only if it rendered a statement made by GS

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* See the Foundation's Brief, Point IV.

unreasonable as opposed to making the statement misleading, thereby imposing a greater burden of proof on the Foundation than required by § 12(2).

Because GS' failure to disclose the omitted facts made the other statements made by GS misleading (although perhaps not unreasonable), supra, even if the aforecited language of the District Court relates to whether GS' statements were misleading in the absence of the omissions (as opposed to relating to the scope of GS' duty to disclose), the District Court nevertheless erred in concluding that GS did not violate § 12(2).

POINT II

THE FOUNDATION PROPERLY ESTABLISHED THAT THE OMISSIONS WERE MATERIAL

In the reply to the Foundation's contention in Point IV of its Brief that the facts which GS omitted to disclose in connection with the sale of Penn Central commercial paper, supra, were material, GS makes the following arguments, each of which will be discussed hereinafter:

(1) the Foundation utilized an improper standard regarding the materiality of the omissions,

(2) the Foundation was required to establish the materiality of the omissions by expert testimony,

(3) because the Foundation did not inquire about the facts which GS omitted to disclose, such facts are not material, and

(4) the case of Chasins v. Smith, Barney & Co. has been reversed by the decisions of Ernst & Ernst v. Hochfelder and TSC Industries, Inc. v. Northway, Inc.

Before considering these arguments, however, it is important to note that, contrary to the statements of GS*, the District Court did not conclude that the omissions of GS were not material. Although it made no express statement, the District Court impliedly held that the omissions were material by concluding that the omissions were "relevant to a judgment of creditworthiness". 422 F. Supp. at 896.** The statement of the District Court that "none of the alleged omissions can be considered necessary 'in light of the circumstances'" to render GS' opinion regarding Penn Central's creditworthiness unreasonable (422 F. Supp. at 895-896) relates not to the issue of the materiality of the omissions but rather to the scope of GS' duty to disclose facts, regardless of their materiality.*** Alternatively, the most GS can argue is that the District Court did not consider the issue of the materiality of the omissions.****

A. THE FOUNDATION ESTABLISHED THE MATERIALITY OF THE OMISSIONS IN ACCORDANCE WITH THE PROPER STANDARD

In Point IV(B) of its Brief, the Foundation set forth the applicable tests for determining the materiality of a fact as articulated by the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), and TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976)*****. Based on these

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* E.g., GS Reply Brief, p. 30.

** If a fact is relevant, by definition it is important or significant and therefore material, infra.

*** See Point I, supra.

**** This Court may nevertheless determine this issue. See the cases cited in the Foundation's Brief, fn., p. 64.

*****Although it quotes, in part, the same language from TSC which is cited by the Foundation, GS inexplicably states that the Foundation has ignored "this Circuit's standard of materiality under the securities laws".

authorities, a fact is material if there is a substantial likelihood that a reasonable investor would consider the fact significant or important in his investment decision. Because a reasonable investor is utilized in determining whether a fact is material, it is clear that the foregoing authorities establish an objective standard for the materiality of a fact. The contention of GS that a subjective standard should be applied* is consequently untenable. In any event, as indicated in its Brief (Point IV), the Foundation has demonstrated that each omission was material pursuant to both an objective as well as a subjective standard.

B. EXPERT TESTIMONY IS NOT NECESSARY TO ESTABLISH THE MATERIALITY OF A FACT

GS maintains that it was incumbent upon the Foundation to establish the materiality of the omissions by expert testimony and, because only the testimony of GS' witnesses was offered which "plainly" established the non-materiality of the omissions, the Foundation failed to prove that the omissions were material. GS Reply Brief, pp. 39-40. Not only is expert testimony unnecessary to prove the materiality of an omitted fact but, expert testimony could not be properly offered with respect to such issue. In any event, contrary to its contention, the witnesses of GS who had expertise in the market "plainly" established the materiality of the omissions.

As noted above, the legal issue with respect to the materiality of a fact is predicated upon the factual determination of whether a reasonable investor would consider the fact

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* Semantically accomplished by placing the reasonable investor "in the objective position occupied by plaintiff." GS Reply Brief, p. 38.

significant or important in his investment decision. The materiality of a fact is therefore dependent upon the state of mind of a reasonable person. Consequently, pursuant to Rule 702 of the Federal Rules of Evidence*, expert testimony is not admissible to prove the materiality of a fact because it is an issue with respect to which no "specialized knowledge" can be acquired and which the trier of fact can therefore determine without the assistance of an expert.

> "In determining whether expert testimony should be admitted, the test...is whether it will assist the trier of fact in understanding the evidence or determining a fact in issue. In Wigmore's words, the crucial question is: 'On this subject can a jury from this person receive appreciable help?'" 3 Weinstein's Evidence ¶702 [01] at 702-5 (footnotes omitted).
>
> "Whether the situation is a proper one for the use of expert testimony is to be determined on the basis of assisting the trier. 'There is no more certain test for determining when experts may be used than the common sense inquiry whether the untrained layman would be qualified to determine intelligently and to the best possible degree the particular issue without enlightment from those having a specialized understanding of the subject involved in the dispute.' Ladd, Expert Testimony, 5 Vand. L. Rev. 414, 418 (1952). When opinions are excluded, it is because they are unhelpful and therefore superfluous and a waste of time. 7 Wigmore §1918." Id. at 702-2.

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* Fed. R. Evid. 702 provides:

> "If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise."

> "...expert testimony concerning the practices of a particular trade or business is not admissible if as a matter of substantive law only the jury's common understanding and not the customary practice or usages are relevant..." Marx & Co., Inc. v. Diner's Club, Inc. 550 F. 2d 505, 509 (2d Cir. 1977), n. 11 (citations omitted).

It is obvious that the state of mind of a person is not an area or subject matter in which an expert would, or could, possess a "specialized knowledge". Absent the existence of any specialized knowledge or expertise with respect to the state of mind of a person, the District Court, as the trier of fact, could not have received any assistance from an expert. Consequently, the District Court could, indeed was required, to determine the issue of whether the omissions were material without the benefit of expert testimony.*

It is presumably for this reason that no case** has been found wherein expert testimony was proffered, much less required, in determining the issue of the materiality of a fact in the context of a securities action. The cases cited by GS*** in connection with its argument that the Foundation was also required to establish the proper standard for a reasonable

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* Prior to the enactment of Fed. R. Evid. 704, expert testimony regarding the reasonable investor's state of mind in the context of the instant case would not have been admissible because it relates to an "ultimate issue" to be determined by the trier of fact. See 3 Weinstein's Evidence ¶¶704 [01] et. seq.

** Including any of the GS-Penn Central cases.

*** SEC v. Geon Industries, Inc., 531 F. 2d 29 (2d Cir. 1976); Manheim v. Wood, Walker & Co., (CCH) Fed. Sec. L. Rep. ¶95,848 (D. Conn. 1976), and Marx & Co., Inc. v. Diner's Club, Inc., 550 F. 2d 505 (2d Cir. 1977).

and adequate credit investigation (of Penn Central by GS as an underwriter, insider and broker-dealer)* are not to the contrary. None of these cases concerned expert testimony with respect to the issue of a reasonable investor's state of mind or the materiality of a fact. In Geon, this Court indicated that expert testimony could have been admitted (although it was not necessarily required) regarding the practice in the securities industry of broker-dealers supervising registered representatives in connection with the issue of whether the supervision by a broker-dealer was negligent. In Manheim, the Court stated (in dicta) that expert testimony in connection with the practice in the securities industry with respect to the discovery and disclosure of facts relating to a company whose stock was recommended by a registered representative could have been offered in evidence. Finally, in Marx, this Court held that expert testimony would be admissible on the issue of the ordinary practices in the securities industry, specifically in connection with the procedure for the registration of securities. None of these cases, however, supports the proposition that the materiality of a fact is a proper subject for, or an issue which must be established by, expert testimony. Indeed, in Geon the Court resolved the issue of whether a fact was material without the benefit of expert testimony. 531 F. 2d at 47-49.

Moreover, the foregoing cases do not support GS' argument that the proper standard for a reasonable or adequate credit investigation had to be established by expert testimony. What

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* GS Reply Brief, pp. 4-10.

constitutes the proper standard for an adequate credit investigation is a legal issue reserved for the court and with respect to which expert testimony is not admissible.

> "Testimony concerning the ordinary practices of those engaged in the securities business is admissible...to enable the jury to evaluate the conduct of the parties against the standards of ordinary practices in the industry.***It is not for witnesses to instruct the jury as to applicable principles of law, but for the judge. As Professor Wigmore has observed, expert testimony on law is excluded because 'the tribunal does not need the witness' judgment...[T]he judge (or the jury instructed by the judge) can determine equally well...' The special legal knowledge of the judge makes the witness' testimony superfluous.*** It is for the jury to evaluate the facts in the light of applicable rules of law, and it is therefore erroneous for a witness to state his opinion on the law of the forum.*** With the growth of intricate securities litigation over the past forty years, we must be especially careful not to allow trials before juries to become battles of paid advocates posing as experts on the respective sides concerning matters of domestic law..." Marx & Co., Inc. v. Diners Club, Inc., supra at 509-511 (citations omitted).

In the instant case, the District Court was presented with the issue, inter alia, of what is the legal standard imposed on GS as a broker-dealer/underwriter/insider by § 12(2) with respect to a credit investigation of Penn Central. This issue is to be contrasted with the issue of whether a particular practice is in conformance with the duty to exercise reasonable care, the issue in Marx, Geon and Manheim. The former relates to establishing the legal standards or duty pursuant to § 12(2) whereas the latter assumes the statutory standard is that of due care or reasonableness and concerns the issue of whether such standard

was satisfied. In this connection, it should be noted that although the District Court used the term "reasonable" in defining the statutory duty of GS, contrary to the arguments of GS, that term does not inject the issue of due care or negligence into the statutory requirements of § 12(2), supra. The only issue is what are the statutory requirements for an adequate credit investigation. See Sanders v. John Nuveen & Co. Inc., 524 F. 2d 1064 (7th Cir. 1975). After reviewing the applicable authorities regarding the duty of investigation of a broker-dealer and of an underwriter, the District Court determined the proper standard for an adequate and reasonable credit investigation as a matter of law (see the Foundation's Brief, pp. 30-33). The testimony of an expert regarding the investigative practices in the securities industry would therefore have been superfluous to, and a substitution of the expert's legal opinion for that of the District Court's in connection with, the legal issue regarding the proper standard of investigation for a broker-dealer/underwriter/ insider. Thus, with respect to establishing the legal parameters of a reasonable and adequate credit investigation, expert testimony was not admissible, much less required.*

Furthermore, even if expert testimony regarding industry practices were admissible with respect to such issue it would not, in any event, be conclusive because the

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* In this connection, no expert testimony was proffered or required in Sanders v. John Nuveen & Co., Inc., supra, wherein the Court confronted the same issue. For the same reasons, non-expert testimony would similarly be superfluous and inadmissible.

entire industry practice could be unlawful or in violation of the securities laws.

> "We do not mean, of course, that this absence of proof [regarding a practice in the securities industry] is conclusive, for a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. [Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission... The T. J. Hooper, 60 F. 2d 737, 740 (2d Cir. 1932) (citations omitted)]." SEC v. Geon Industries, Inc., supra at 52.

> "However, even where a defendant is successful in showing that it has followed a customary course in the industry [*], the first litigation of such a practice is a proper occasion for its outlawry if it is in fact in violation. See Opper v. Hancock Securities Corp., 250 F. Supp. 668, 676 (S.D.N.Y. 1966), aff'd 367 F. 2d 157 (2d Cir. 1966)." Chasins v. Smith, Barney & Co., 438 F. 2d 1167, 1171 (2d Cir. 1970).

A contrary holding would permit the securities industry, by "practice", to unilaterally eliminate all of its legal responsibility under the securities laws.

However, even assuming arguendo that expert or other testimony was necessary to establish the materiality of the omissions, the testimony of GS' witnesses clearly satisfied this requirement. In discussing the materiality of the following

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* Since GS called no witnesses to testify regarding the practice of other broker-dealers or underwriters with respect to the credit investigation of a commercial paper issuer, the "customary" practice was not established by GS at trial.

omissions in its Brief, the Foundation relied, inter alia, upon the statements and/or testimony of the following witnesses to establish that the omitted facts were important or significant to such witnesses or to the average investor:

(1) Inventory Omission - Wilson (66)*.

(2) Banklines Omission - Levy (71, 75, 78), Wilson (73, 74, 75, 77, 78), Van Cleave (73), Vogel (76, 78), Hansell (78), Harre (78), Stutt (78), Tolan (78) and Brenkert (78).

(3) Brown Bros. Omission - Wilson (84).

It is clear, and GS does and cannot dispute, that Wilson, Van Cleave and Vogel were qualified experts with respect to the commercial paper market by virtue of the fact that they occupied the positions of partner in charge of the commercial paper department [Tr. 836, 836a], vice president of the commercial paper department [Tr. 224, 224a] and the head of the credit department [Tr. 468,468a] of GS respectively. Although GS maintains that Levy is not an expert, his experience in the securities market for in excess of thirty three years and his position as the senior partner of GS [Tr. 730-732, 730a] clearly qualified him as such. See Fed. R. Evid. 702. Similarly, the positions of the following individuals qualified them as experts in, or at least sufficiently knowledgeable to testify regarding, the commercial paper market:

Hansell - GS commercial paper salesman [Hansell Dep. 3, 1163a].**

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* Parenthetical references are to pages in the Foundation's Brief.

** The objection of GS to the relevance of the testimony of Hansel, Harre, Stutt and Brenkert (GS Reply Brief, p. 40) is without merit as their testimony relates to the materiality of an omitted fact.

Harre - GS commercial paper salesman [Harre Dep. 3, 1172a].

Stutt - GS vice president of corporate finance [Stutt Dep. 3, 1199a].

Tolan - GS national sales manager who supervised and analyzed the commercial paper department [Tolan Dep. 3, 1205a].

Brenkert - GS commercial paper salesman [Brenkert Dep. 2, 1145a].

Consequently, any expert or other testimony which was required to establish the materiality of the omissions was properly adduced by the Foundation through the witnesses of GS.

C. THE MATERIALITY OF A FACT CANNOT BE DEPENDENT UPON THE INQUIRY OF A PURCHASER

GS implies that if a purchaser makes no inquiry regarding a fact, that fact cannot be material.* This contention is untenable for two reasons. Firstly, an "inquiry test" for materiality would contradict the prevailing standards for the materiality of a fact as set forth in Affiliated Ute Citizens v. United States and TSC Industries, Inc. v. Northway, Inc., supra. It would mean that even if a reasonable investor would or should have considered a fact significant or important in making his investment decision, unless he asked the broker-dealer/underwriter/insider about such fact, the fact would not be material. For example, there would presumably be no dispute that if Penn Central had filed a petition in bankruptcy on the afternoon of March 12, 1970, such fact would have been important to the Foundation (or anyone else) in purchasing Penn Central commercial

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* See GS Reply Brief, p. 45.

paper. Nevertheless, if this fact were not disclosed to the Foundation by GS on March 13, 1970 in connection with its purchase of commercial paper and if the Foundation did not ask GS whether Penn Central had gone bankrupt, the bankruptcy of Penn Central would not constitute a material fact pursuant to the "inquiry test".

The anomaly presented by the foregoing example demonstrates the second basis upon which the "inquiry test" is unsupportable. If the materiality of a fact were dependent upon the inquiry of the purchaser of a security, the entire responsibility for disclosure by broker-dealers/underwriters/ insiders in the securities market would be reversed. Instead of the broker-dealer/underwriter/insider being charged with the affirmative duty of disclosing material facts in acccrdance with existing law* it would be incumbent upon the purchaser, who almost always will be less sophisticated,** to literally cross-examine and inquire of the broker-dealer/underwriter/ insider with respect to every aspect of the issuer's financial condition and business. Thus, in the foregoing example, regardless of the fact that Penn Central may have had the image of a "huge industrial company...as safe as the U.S. Government"***, unless the Foundation asked GS the seemingly preposterous question of whether Penn Central was

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* See the Foundation's Brief, Point IV.

** Compare the Foundation's (Fitzpatrick and LeMay) lack of sophistication with the expertise of Wilson.

*** The image of Penn Central to Fitzpatrick [Tr. 113, 113a].

bankrupt, no liability would attach for nondisclosure of that fact. The securities laws, and the resulting authorities, neither contemplate nor permit this transference of responsibility for disclosure from the broker-dealer/underwriter/insider to the purchaser. The "inquiry test" is therefore clearly an improper, indeed impossible, standard for determining the materiality of a fact.

D. THE HOLDING IN CHASINS WITH RESPECT TO MATERIALITY HAS NOT BEEN REVERSED BY ERNST & ERNST OR TSC

At page 43 of its Reply Brief, GS states:

> "By predicating liability upon facts which merely suggested an improper motive, Chasins is inconsistent both with the conclusion of Ernst & Ernst that an actual intent to deceive, manipulate or defraud is necessary and with the conclusion of TSC that the fact must be one which was substantially likely to affect the investment decision in question."

GS' claim that Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), and TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), have stripped the decision in Chasins v. Smith, Barney & Co., 438 F. 2d 1167 (2d Cir. 1970), of its vitality is without merit.* GS argues that Chasins was a Rule 10b-5 case in which no finding of scienter was made and therefore it is inconsistent with Ernst

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* The courts in the following cases decided after Ernst & Ernst and TSC cited Chasins with approval in the context of a discussion of materiality: Freidlander v. City of New York, 71 F.R.D. 546, 549 (S.D.N.Y. 1976); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F. 2d 27, 35 (2d Cir. 1976); Manheim v. Wood, Walker & Co., (CCH) Fed. Sec. L. Rep. ¶95,848 (D. Conn. 1976). In addition, Chasins was cited with approval by the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972): "This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. Chasins v. Smith, Barney & Co....."

& Ernst. However, assuming arguendo such an inconsistency, it is irrelevant for purposes of this appeal because the main thrust of Chasins and the purpose for which the Foundation cited it remains intact:

> "These cases [Chasins and Dale v. Rosenfeld, 229 F. 2d 855 (2d Cir. 1956)] held that facts which pertain to the relationship between the company which recommends and sells a security and the issuer of that security are material to an investor who relies upon the company's recommendation of the security and the company's judgment of the issuer." Foundation Brief, p. 68.

As the following quotations demonstrate, there can be no dispute that the major issue in Chasins was the materiality of the defendant's omission (and the court's holding with respect to materiality has the same effect under §12(2) of the 1933 Act as it does under Rule 10b-5 of the 1934 Act):

> "Smith, Barney's major contention in attacking the district court's finding of a violation of Rules 10b-5 and 15c1-4 is that failure to disclose its 'market making' role in the securities exchanged over the counter was not failure to disclose a material fact." 438 F. 2d at 1170.

> "However, the fact that dealing with a market maker should be considered by some desirable for some purposes does not mean that the failure to disclose Smith, Barney's market-making role is not under the circumstances of this case a failure to disclose a material fact. The question here is not whether Smith, Barney sold to Chasins at a fair price but whether disclosure of Smith, Barney's being a market maker in the...securities might have influenced Chasins' decision to buy the stock." Id. at 1171.

Similarly, TSC does not affect the "materiality" holding of Chasins. Insofar as TSC is relevant here, the Supreme Court (in ruling on an interlocutory appeal), after setting forth the appropriate standard of materiality under Rule 14a-9 of the 1934 Act, reversed (and remanded) a grant of partial summary judgment to TSC with respect to two omissions which TSC in its summary judgment motion alleged were material as a matter of law. One omission centered on the failure of the challenged proxy statement to disclose that National (the acquiring company) and Madison, a mutual fund (of which National's chairman was a director), had acquired 8.5% of National's common stock over a period of time. Apparently, no evidence was offered to establish that these stock purchases affected the price of National's stock which was being offered to TSC shareholders in exchange for their TSC stock. The Court of Appeals held that these omissions were material as a matter of law. The Supreme Court reversed the Court of Appeals on this issue (and remanded) because of factual issues with respect to the existence of manipulation and whether the manipulation had any effect on the price of the National common stock (i.e., did the alleged manipulation affect the fairness of the proposed exchange offer). Accordingly, the Supreme Court held if there was no manipulation, the challenged purchases "had no bearing on the soundness and reliability of the market prices listed in the proxy statement and it cannot have been materially misleading to fail to disclose them [23] [*]". 426 U.S. at 462. The Supreme Court by this

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* "23 - In holding that the failure to disclose the National and Madison purchases violated Rule 14a-9 as a matter of law, the Court of Appeals not only found it unnecessary to consider whether
(footnote continued on next page)

ruling, wherein the issuer and seller of the security were the same entity, did not intend to affect the Chasins principle that an undisclosed relationship between an issuer and a separate seller of securities which created the possibility of a conflict of interest for the seller was a material omission.* This is made clear by the Court's ruling with respect to National's failure to disclose that National employees were chairmen of TSC's board of directors and executive committee at the time TSC and National issued a joint proxy statement with respect to the exchange of TSC stock for National stock. The Court of Appeals in passing on the motion for summary judgment ruled that this omission was material as a matter of law. In reversing and remanding, the Supreme Court stated:

(footnote cont'd.)
there was in fact any collusion or manipulation, but also found it unnecessary to consider whether the purchases had any significant effect on the price of National Common Stock or, more pertinently, the price of the National Preferred Stock and Warrants involved in the proposed transaction. Since we find the existence of a genuine issue of fact with respect to whether there was manipulation sufficient to bar summary judgment, it is unnecessary to consider the remaining aspects of the Court of Appeals' decision." 426 U.S. at 463.

* In TSC the Supreme Court noted:

"We are aware, however, that the disclosure policy embodied in the proxy regulations is not without limit. See id., at 384. Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholder in an avalanche of trivial information - a result that is hardly conducive to informed decisionmaking." Id. at 448 . As opposed to the "avalanche" of information given stockholders in a proxy statement, commercial paper investors receive, at most a mere pebble. Accordingly, the Supreme Court's fears under Rule 14a-9 are not relevant to a §12(2) claim by a commercial paper investor.

> "The proxy statement prominently displayed the facts that National owned 34% of the outstanding shares in TSC, and that no other person owned more than 10%... It also prominently revealed that five out of ten TSC directors were National nominees, and it recited the positions of those National nominees with National - indicating, among other things, that Stanley Yarmuth was president and a director of National, and that Charles Simonelli was executive vice president and a director of National... These disclosures clearly revealed the nature of National's relationship with TSC and alerted the reasonable shareholder to the fact that National exercised a degree of influence over TSC. In view of these disclosures, we certainly cannot say that the additional facts that Yarmuth was chairman of the TSC board of directors and Simonelli chairman of its executive committee were, on this record, so obviously important that reasonable minds could not differ on their materiality." 426 U.S. at 452 (emphasis supplied).

The underlined language demonstrates the Supreme Court's support for the Chasins rationale. If it believed otherwise, the Court obviously would have stated that there could be no liability for this omission absent proof that National had exercised its influence over TSC to the detriment of TSC shareholders. Consequently, the Foundation's contention that the inventory omission was material under Chasins remains valid.*

E. FURTHER EVIDENCE THAT THE BROWN BROS. OMISSION WAS MATERIAL

In arguing that the Brown Bros. omission was not material, GS overlooks the fact that Penn Central's reaction and its own reaction to the fact that Brown Bros. had removed Penn Central from its list of approved issuers on February 5, 1970, and the

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* Although GS challenges Chasins applicability to the inventory omission, it remains silent with respect to its applicability to the bank lines omission. See the Foundation's Brief, p. 82.

"importance attached" to this fact by GS and Penn Central, establish the materiality of this omission. SEC v. Shapiro, 349 F. Supp. 46, 54 (S.D.N.Y. 1972), aff'd, 494 F. 2d 1301 (2d Cir. 1974). GS felt that Brown Bros. conduct was sufficiently important to relate to Penn Central at the February 6, 1970 Penn Central -GS luncheon* and, upon learning of Brown Bros. conduct, Penn Central thought it sufficiently important to request that GS arrange a meeting with Brown Bros. to find out why the removal had occurred. [PX-12, 1719a; Tr. 956, 956a].

F. THERE WAS NO EVIDENCE THAT THE BANKLINES WERE CANCELLABLE AT WILL AND THEREFORE THE BANKLINE OMISSION WAS MATERIAL

In arguing that GS' failure to disclose that Penn Central would not or could not obtain 100% bank line coverage for its commercial paper despite GS' continuous requests that it do so was not material, GS asserts that the "evidence at trial consistently demonstrated that bank lines are cancellable at will and thus provide little if any protection in times of economic stress". GS Reply Brief, p. 45. On the contrary, however, the evidence at trial established that Penn Central was able to, and did in fact, use most of its commercial paper bank lines of credit. At the outset it should be noted, as this Court found:

> "Bank credit lines are 'open credit lines [that] range from informal understandings between the bank and the issuer to formal revolving credit agreements between the two parties..." Franklin Savings Bank

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* "I [Wilson] told him [O'Herron] about a large New York firm [Brown Bros.] that has bought as much as 15% of their outstandings and which only yesterday temporarily removed their name from the approved list. We are going to try and set up an appointment for John O'Herron to visit the firm". [PX-12, 1719a].

of New York v. Levy, 551 F. 2d. 521, 523 (2d Cir. 1977), n. 5.

GS did not introduce any evidence whatsoever as to the formality or informality of any of the terms of the $100,000,000 in commercial paper banklines extended to Penn Central by various banks.* There was no evidence that the bank lines were "cancellable at will" or could not be used in "times of economic stress." Indeed, the evidence proves just the opposite. Thus, Van Cleave, the number two man in GS' commercial paper department, testified with respect to bank lines:

> "It is strictly a type of line that is set up for the marketing just in case for some reason if there was any disaster, let's say in the economy or somebody dropped a bomb somewhere, notes couldn't be sold, that these lines would be available to pick up the commercial paper maturities." [Tr. 305, 305a].

More importantly, the undisputed evidence showed that of the $100,000,000 in bank lines supporting Penn Central's commercial paper, $96,000,000 were actually used in the Spring of 1970 by Penn Central [Lepley Dep. 32, 1186a ; Sullivan Franklin (DC) Tr. 878-879, 1114a]. Two million dollars of the $96,000,000 came from Brown Bros. as a result of a commitment made by Brown Bros. in August 1968. [PX-34, 1728a; DX-BY, 1889a]. Although there was no evidence at trial as to whether the Brown Bros. $2,000,000 bankline was a confirmed line (which could not be withdrawn), it appears that it must have been in view of the fact that in

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* Curiously, the only document that GS introduced in evidence which reflected the actual terms of a bank line agreement was a letter dated August 8, 1974 pursuant to which Manufacturers Hanover Trust Company extended a line of credit to Niagara Mohawk Power Corporation. [DX-FI, 1923a].

February 1970 Brown Bros. manifested its uncertainty as to Penn Central's creditworthiness by removing Penn Central from its list of approved issuers of commercial paper and nonetheless honored its bankline commitment.

POINT III

THE NCO PRIME ISSUE HAS NOT ALWAYS BEEN DECIDED IN FAVOR OF GS

At pages 48 and 49 of its Reply Brief, GS contends that the Foundation's "strident" claim that NCO'S "prime" rating of Penn Central commercial paper was based on GS' decision to continue to sell the paper after February 4, 1970 "lacks conviction in view of the fact that no trial court considering this issue has agreed with plaintiff's position."* GS' summary of the rulings of the trial courts which have considered this issue, however, requires amplification.

In Welch Foods, Inc. v. Goldman, Sachs & Co., 70 Civ. 4811-CLB (S.D.N.Y. 1974), the jury rendered a verdict against GS

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* GS also asserts that the SEC Staff Report to the Special House Subcommittee on Investigations entitled "The Financial Collapse of the Penn Central Company" [PX-113, for identification; 1801a] was properly excluded by the District Court because it "primarily consists of opinions and conclusions..." However, a review of this Report to a Congressional Committee reveals that it primarily consists of facts compiled by the SEC in the course of its investigation of 200 witnesses and thousands of documents pursuant to § 21(a) of the 1934 Act and, therefore, should have been admitted in evidence under Fed. R. Evid. 803(8). In this connection, it should be noted that the proper test for consideration of this issue is not, as GS contends (GS Reply Brief, p. 50), whether the District Court abused its discretion. The applicable standard for review is whether "...the primary evidence upon which the District Court based its interpretation was a document(s) which this Court is 'in as good a position as the trial judge to interpret...'" Kind v. Clark, 161 F. 2d 36, 46 (2d Cir. 1947). See the Foundation's Brief, fn., p. 90.

pursuant to § 12(2) of the 1933 Act and Rule 10b-5 of the 1934 Act. Although it is impossible to state upon which omissions the jury relied in reaching its verdict, it is relevant to note that Judge Brieant permitted the issue of whether GS' failure to disclose the Rogers-Vogel telephone conversation on February 4, 1970 was a material omission, to go to the jury. Id. Trial Transcript, pp. 3078-3079.

The following ruling of Judge Metzner in Franklin (DC) has not been disturbed on appeal:

> "The only trouble with Goldman Sachs' position is that the rating organization [NCO] appears to have continued the prime rating on February 5 in reliance on defendants' decision to continue to sell this paper despite adverse news as to the financial condition of Penn Central." Franklin (DC) at 44.

Contrary to the implied contention of GS, the opinion in Mallinckrodt Chemical Works v. Goldman, Sachs & Co., 420 F. Supp. 231 (S.D.N.Y. 1976), does not support GS' position:

> "On that date [February 5, 1970] however, Rogers called Vogel of Goldman, Sachs and expressed concern over the sharply reduced earnings. According to Vogel, Rogers asked him whether Goldman, Sachs was continuing to sell PCTC commercial paper and whether he, Vogel, felt that PCTC had sufficient assets to pay down debt. Vogel answered both questions in the affirmative. If he knew, Vogel did not divulge to Rogers that Goldman, Sachs had been shocked by the loss for the fourth quarter, which had been expected to show a profit. Nor did anyone disclose to NCO that Robert Wilson, head of the Commercial Paper Department of Goldman, Sachs, had called O'Herron of PCTC on February 5, 1970 about the bad news and told him that 'it was unfortunate that we did not have some indication of the magnitude of the total losses for 1969, as we are going to need a story to tell existing holders of Penn Central's paper and new

purchasers of paper.' While Goldman, Sachs indicated to O'Herron that it would continue to offer this paper, including the $15-odd million that Goldman, Sachs had in its own inventory, Wilson did explore the possibility of PCTC buying back this inventory out of bank credit lines then available to it. No one advised NCO that on February 5, 1970 Brown Brothers Harriman & Co., who had held as much as 15% of the total outstanding paper of PCTC through purchases from Goldman, Sachs, had removed that paper from their approved list, nor was NCO informed that Goldman, Sachs had met with O'Herron and other officials of PCTC on February 6, at which time it was divulged that PCTC had a budgeted loss of $56 million for 1970, which, when added to $170 million of additional necessary financing resulted in a cash requirement of $226 million for that year. Of this $226 million, Goldman, Sachs was advised that $70 million had already been arranged for, that PCTC would attempt a $100 million bond sale in the future, but that it would seek a $50 million 'bridge' loan in the meantime. Likewise, there was no mention that on February 9, 1970 PCTC bought back $10 million of its paper from Goldman, Sachs, reducing the latter's inventory to just below $5 million." Id. at 238-239.

"Plaintiff has attempted to show that NCO continued PCTC's 'prime' rating upon the affirmation by Goldman, Sachs that it would continue to market the PCTC paper. If this was a factor behind NCO's conclusion to continue the rating, it was not an improper one. Goldman, Sachs was the exclusive agent for the PCTC paper and accordingly a reliable source of information. Green v. Jonhop, Inc., 358 F. Supp. 413, 421 (D. Ore. 1973). There is no evidence that NCO was aware either than [sic] Goldman, Sachs owned a substantial amount of the paper or, more important, that Goldman, Sachs had arranged for the repurchase of much of that paper by the issuer." Id. at 242.

Finally, although the language from Alton Box Board Company v. Goldman, Sachs & Co., 418 F. Supp. 1149 (E.D. Mo. 1976), upon which GS relies is similar to language in Judge Lasker's opinion (422 F. Supp. at 896-897), it should be noted that the appeal in Alton Box is sub judice and, in any event, the decision is distinguishable. In Alton Box, the Court reasoned:

> "When the hearsay statement attributed to Mr. Rogers is considered along with other evidence regarding the ongoing granting of credit to the Penn Central Transportation Company by various other large financial institutions, such as plaintiff's agent, First National, the hearsay statement pales in significance and importance in relationship to the other direct evidence. After careful weighing of the evidence it is the opinion of the Court sitting as the trier of fact that the plaintiff has failed to prove that defendant Goldman, Sachs was responsible for the continued 'Prime' rating of the Penn Central Transportation Company by NCO." Id. at 1156.

The Court's reliance upon "other direct evidence" in Alton Box and the plaintiff's relationship with its agent, First National (a lender to Penn Central which "was engaged in an ongoing financial analysis of" Penn Central (Id. at 1153)), make the Alton Box decision distinguishable from the instant case.

CONCLUSION

By reason of the foregoing, and for the reasons set forth in the Principal Brief of the Foundation, the decision of the District Court should be affirmed.

Dated: June 27, 1977

Respectfully submitted,

SOLIN & BREINDEL
Attorneys for University Hill Foundation
645 Fifth Avenue
New York, New York 10022
(212) 752-4407

A 202 Affidavit of Personal Service of Papers — LUTZ APPELLATE PRINTERS, INC.

COURT OF APPEALS
SECOND CIRCUIT

UNIVERSITY HILL FOUNDATION,
Plaintiff-Appellee and Cross-Appellant,

- against -

GOLDMAN SACHS & CO.,
Defendant-Appellant & Cross-Appellee.

Appeal fro the U.S. Dist. Court for the Southern Dist. of N.Y.

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF *ss.:*

I, Kevin E. Thomas, being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at 1515 Macombs Road, Bronx, N Y. 10452,

That on the 18th *day of* **July** *19*77 *at* **48 Wall Street New York, New York**

deponent served the annexed *upon* **Sullivan & Cromwell, Esqs.**

the ~~Reply~~ **Brief** *in this action by delivering a true copy thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the herein,*

Sworn to before me, this **18th**
day of **July,** *19* **77**

Kevin E. Thomas
Print name beneath signature
KEVIN E. THOMAS

Robert T. Brin

ROBERT T. BRIN
NOTARY PUBLIC, State of New York
No. 31-0418950
Qualified in New York County
Commission Expires March 30, 1979